11-2014

Do Asian conglomerates offer attractive risk-adjusted returns?

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DO ASIAN CONGLOMERATES OFFER Attractive risk-adjusted returns?

Research on a sample of seven Asian conglomerates shows that stocks of some of these companies not only outperformed the S&P 500, but also exhibited lower volatility.

By Nandini Vijayaraghavan

Equity markets typically ascribe a discount to the valuation of conglomerates, where the market value of a conglomerate is lower than the sum of the values of the individual businesses, due to lower synergy among component businesses and, in certain cases, a complex organisation structure. But debt markets, especially in Asia, view conglomerates favourably, with the debt issuances of these entities frequently being over-subscribed and credit rating agencies ranking these issuances as investment grade.

The intrinsic strength of Asian conglomerates and the fact that their businesses are focused on high growth economies outside the United States, implies that their stocks ought to generate robust medium- to long-term returns and the correlation of returns with the S&P 500 returns must be low. If this premise is correct, then fund managers managing USD-denominated portfolios that are geography and sector agnostic should be able to enhance the return and diversity of their portfolios by investing in Asian conglomerate stocks. Surprisingly, my research shows that this is not the case.

TABLE 1: KEY FINANCIAL INDICATORS AND BUSINESS-WISE OPERATING PROFITS

	Year End	Market Capitalisation as of 9-Sep-14 (US$M)	Assets (US$M)	Revenues (US$M)	EBITDA Margin	Lease-Adjusted Debt (US$M)	Cash (US$M)	Net Debt/ EBITDA (Times)	Key Businesses (as % of EBITDA)	Geographic Exposure
HWL	31-Dec-13	56,354.74	105,169	33,044	37.3%	31,933	13,255	1.51	Cheung Kong Infrastructure: 24%, Ports, Property & Hotels: 15%, Retail & Husky Energy: 15%, 3G Europe: 13%, Others: 3%	Europe: 39% of EBITDA, Mainland China, Canada & Rest of Asia & Australia: 15% each aggregating 45%, Hong Kong 14%, Others 2%
RIL	31-Mar-14	56,062.61	71,763	66,445	8.8%	14,800	6,129	1.48	Refining: 47%, Petrochemicals: 28%, Oil & Gas: 18%, Others: 7%	India: 32% of revenues & 88% of assets. Outside India: 68% of revenues & 12% of assets
JMH	31-Dec-13	42,824.89	63,835	39,465	11.5%	11,652	5,214	1.42	Astra: 56% of EBIT, Hong Kong Land: 26%, Dairy Farm: 15%, Others: 3%	Southeast Asia: 53% of net income, Greater China 43%, UK & Others 4%
SMC	31-Dec-13	4,170.67	26,428	16,888	10.3%	11,929	4,346	4.34	Power: 34%, Beverage: 27.4%, Petron: 19.4%, Food: 9.7%, Packaging: 3.9%, Others: 5.6%	Not reported, predominantly in the Philippines
KC	31-Dec-13	15,472.87	23,699	9,762	16.3%	6,213	4,388	1.15	Off-Shore & Marine: 50%, Property: 42%, Infrastructure: 6%, Others: 2%	Singapore: 75% of external sales, Americas: 11%, Far East & ASEAN: 9%, Others: 5%
CRE	31-Dec-13	6,611.74	20,026	18,856	6.0%	7,612	2,776	4.31	Beer: 50%, Retail: 42%, Food: 5%, Beverage: 3%	Mainland China: 94%, Hong Kong: 5%, Others: 1%
SIME	30-Jun-13	18,194.43	15,353	14,831	12.7%	3,226	1,297	1.03	Plantation: 39%, Industrial: 27%, Motors: 14%, Property: 9%, Energy & Utilities: 5%, Others: 6%	Malaysia: 50% of EBIT, Australasia: 21%, Indonesia: 16%, China: 7%, Singapore: 6%, Others: Less than 1%

Source: Bloomberg, Company Annual Reports, Author's analysis

To test the proposition whether Asian conglomerate stocks offer superior risk-adjusted returns, I first compared the **stock performance** of seven of the largest Asian conglomerates against the S&P 500. Second, in order to measure stock volatility, the **standard deviations** of stock returns were benchmarked against that of the S&P 500. Third, to understand the dispersion of returns relative to the average, I also looked at the **co-efficient of variation** (CV) of individual stocks. Finally, the historical and projected **price earnings ratios** (P/E) of the companies were compared with those of the S&P 500 and American and European conglomerates to ascertain whether the stocks were priced attractively.

Based on the various indicators, my results show that despite the superior performance and lower volatility of Asian conglomerates, some of these stocks continue to be undervalued and hence potentially present an attractive investment opportunity.

Performance and volatility of Asian conglomerates

The seven short-listed conglomerates include Hutchison Whampoa Limited (HWL), Reliance Industries Limited (RIL), Jardine Matheson Holdings (JMH), San Miguel Corporation (SMC), Keppel Corporation (KC), China Resources Enterprises (CRE) and Sime Darby Berhad (SIME).[i] These conglomerates have well-established businesses that span developed and emerging economies. They also have a long track record of generating robust operating cash flows, and possess strong and liquid balance sheets. Many of them have forged deep relationships with capital markets that translate into a diversified funding profile with competitive funding costs. Table 1 provides the key financial characteristics and business-wise operating profits of the seven conglomerates.

The reason for benchmarking individual stock performance to the S&P 500 is twofold. First, the index may be regarded as a conglomerate/diversified company with exposure to multiple businesses. Second, there exists no index to track the performance of conglomerates. Country-wise equity investment data indicates that the U.S. continues to be the preferred destination for non-domestic equity investments. According to the International Monetary Fund's 2012 Coordinated Portfolio Investment Survey, the U.S. has the highest quantum of outstanding non-domestic equity investments, accounting for 16.14 percent of the US$16.95 trillion of global equity assets, followed by the U.K. (10 percent), Luxembourg (9.8 percent), Cayman Islands (6.45 percent) and Japan (4.71 percent).

TABLE 2: STOCK PERFORMANCE OF ASIAN CONGLOMERATES AND THE S&P 500

	1 year (July 1, 2013 to June 30, 2014)	3 years (July 1, 2011 to June 30, 2014)	5 years (July 1, 2009 to June 30, 2014)	10 years (July 1, 2004 to June 30, 2014)	14.5 years (January 1, 2000 to June 30, 2014)
HWL	31.4%	-49.5%	-16.3%	-19.7%	-63.6%
RIL	15.3%	-8.6%	-15.7%	280.1%	524.9%
JMH	-3.3%	6.0%	111.8%	434.3%	1452.6%
SMC	-6.9%	-30.3%	67.4%	46.2%	38.2%
KC	4.3%	0.7%	60.3%	n.a.	n.a.
CRE	-12.0%	-33.3%	n.a.	n.a.	n.a.
SIME	-2.4%	-3.7%	70.0%	n.a.	n.a.
S&P 500	21.7%	46.8%	118.5%	74.4%	36.1%

Source: Yahoo Finance, Author's analysis

TABLE 3: STANDARD DEVIATION OF STOCK RETURNS OF ASIAN CONGLOMERATES AND THE S&P 500

	1 year (1 July 2013 to 30 June 2014)	3 years (1 July 2011 to 30 June 2014)	5 years (1 July 2009 to 30 June 2014)	10 years (1 July 2004 to 30 June 2014)	14.5 years (1 January 2000 to 30 June 2014)
HWL	0.7%	0.5%	1.0%	0.5%	0.4%
RIL	0.6%	0.2%	0.3%	0.3%	0.2%
JMH	1.4%	0.7%	0.8%	0.6%	0.5%
SMC	0.8%	0.7%	0.6%	0.3%	0.2%
KC	0.1%	0.1%	0.1%	n.a.	n.a.
CRE	0.2%	0.1%	n.a.	n.a.	n.a.
SIME	0.1%	0.03%	0.03%	n.a.	n.a.
S&P 500	36.3%	30.3%	20.7%	9.5%	6.6%

Source: Yahoo Finance, Author's analysis

The stock prices considered are the closing prices with dividends. The USD-denominated returns of the stocks are considered in order to facilitate comparison among the short-listed stocks, as well as the S&P 500. The USD-denominated returns of the stocks would also be more relevant to overseas institutional investors and asset managers than local currency returns. The data analysis runs from January 1, 2000 to June 30, 2014, except in cases where the companies were not listed for the entire 14.5 year period.[ii]

My results indicate that three companies from the sample—JMH, RIL and SMC—outperformed the S&P 500, which registered an aggregate return of 36.1 percent during the 14.5-year period. The returns generated by RIL and SMC are particularly impressive considering the fact that the Indian Rupee and the Philippine Peso are weak currencies that have almost consistently depreciated against the US$ during the period under consideration. Comparable data was not available for KC, CRE and SIME. HWL was the only company that generated negative 64 percent returns (refer to Table 2 for detailed results).

The standard deviations of stock returns, a measure of stock volatility, point to a counter-intuitive trend.[iii] The S&P 500 is the most volatile of the sample during the period January 1, 2000 to June 30, 2014. The standard deviation of all stock returns denominated in US$ was significantly lower than the S&P 500 standard deviation (refer to Table 3). This is despite the SARS outbreak that occurred in Asia during 2002-03. As the S&P companies were most affected by the 2008 global financial crisis, it is understandable that the 10-year and 14.5- year volatility of the S&P 500 exceeds those of the Asian conglomerate stocks.

But what is striking is that Asian conglomerate stocks were more stable than

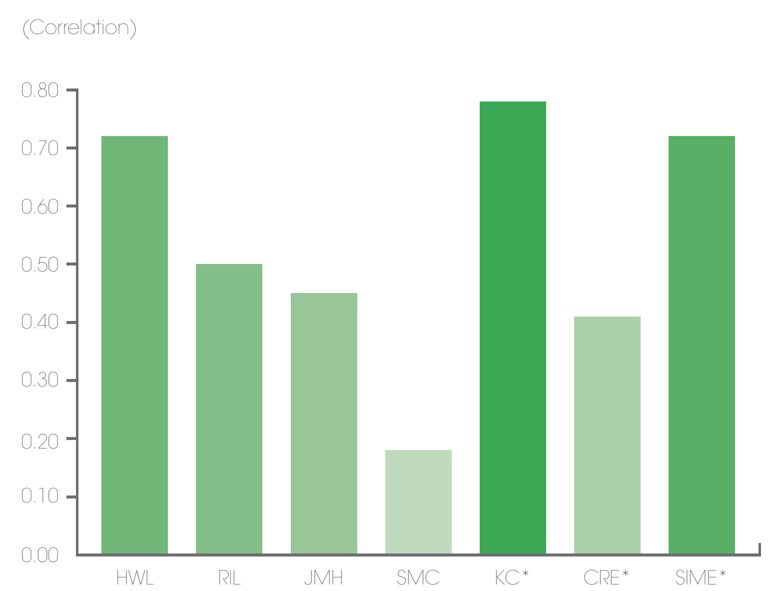
Asian conglomerate stocks were found to be more stable than the S&P 500 even during the five-year period after the global financial crisis.

the S&P 500 even during the five year period after the global financial crisis. More research is required in this area to identify the contributory factors.

To interpret the standard deviation of returns in relation to the mean return, the co-efficient of variation (CV) i.e. the ratio of the period standard deviation to the period mean is calculated. This parameter indicates the dispersion of returns relative to the mean. A lower ratio indicates greater stability of returns. RIL and JMH, with a CV of 1.56% and 1.66%, respectively, were the most attractive stocks on a risk-adjusted basis during the period under consideration.[iv] The two companies' geographically diversified businesses in countries with growing affordability and their strong market positions underpin their robust historical performance and favourable prospects. SMC (3.22%) and KC (3.37%) also registered significantly lower volatility than that of the S&P 500, which was 11.05%.

Another interesting observation is that with the exceptions of KC (bulk of whose business is Singapore-centric), HWL (operates predominantly in investment grade economies including Hong Kong, Europe, Singapore, China, and Australia) and SIME (which mostly operates in Malaysia, Singapore, Australia and China), all other stocks exhibit low to medium correlation with the S&P 500.[v] A significant contributory factor is that these companies' businesses are all non-U.S. centric (refer to Figure 1). The low CV and correlation of Asian conglomerate stocks with the S&P 500 supports the hypothesis that fund managers managing geography agnostic portfolios could invest in Asian conglomerate stocks to enhance portfolio return and stability.

FIGURE 1: CORRELATION OF INDIVIDUAL STOCKS WITH THE S&P 500



* Correlation is computed from 2007 for Keppel Corporation, 2009 for China Resources Enterprises and 2008 for Sime Darby

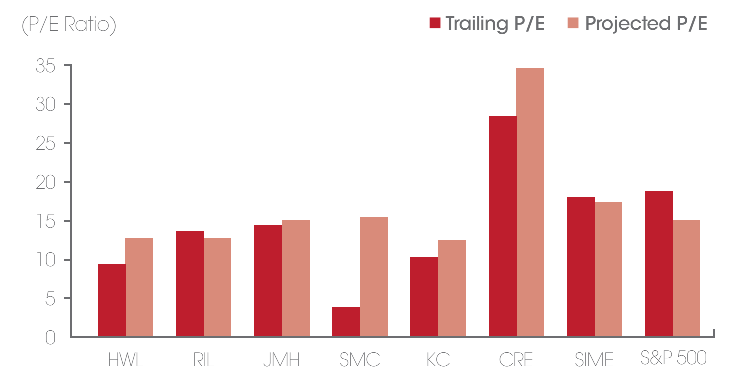
Source: Yahoo Finance, Author's analysis

The historical and projected price earnings (P/E) ratios of the companies were compared with those of the S&P 500 to ascertain that the stocks were priced attractively (refer to Figure 2).[vi] The trailing and projected P/E ratios support the return-volatility analysis presented above. Barring CRE (that has had a prolonged run of poor earnings), SMC and SIME, the trailing and projected P/E ratios of all other stocks are lower than the S&P 500.

Next, the P/E ratios of the Asian conglomerates were benchmarked against the P/E ratios of four of the largest global conglomerates–two U.S.-based and two European conglomerates, details of which are provided below in Table 4.

It is evident that the largest Asian conglomerates are of smaller size (in terms of total assets) than their American and European counterparts. However, it must be noted that

FIGURE 2: PRICE EARNINGS RATIO OF CONGLOMERATES COMPARED WITH S&P 500



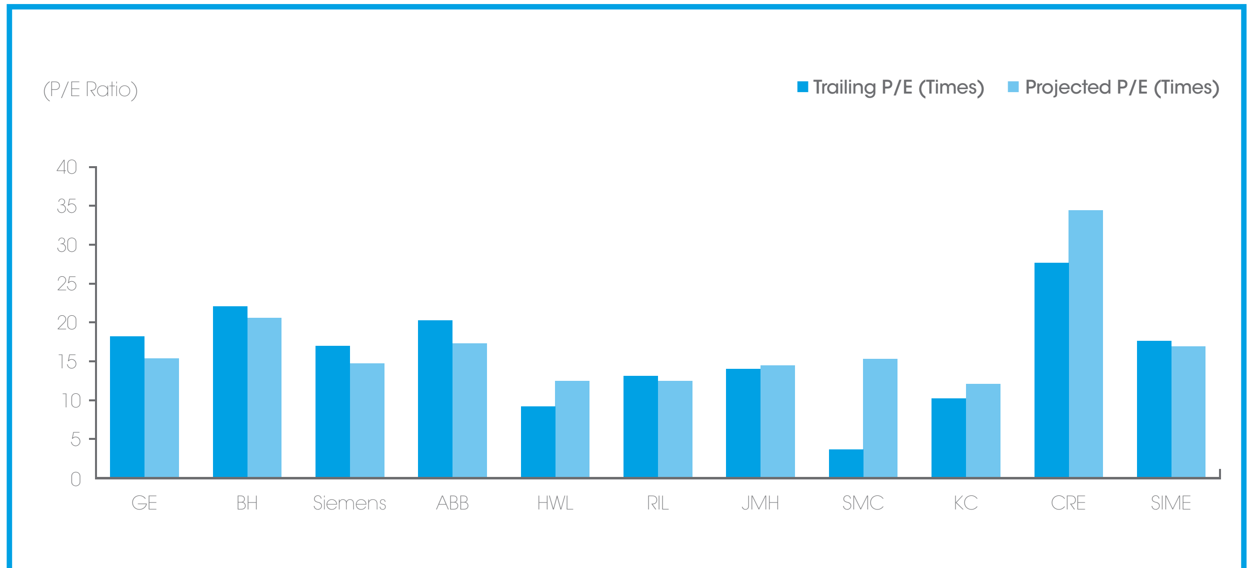
Source: Bloomberg

TABLE 4: PRICE EARNINGS RATIO OF NON-ASIAN CONGLOMERATES

	Headquarters	Year End	Total Assets (US$M)	Market Capitalisation as of 9-Sep-14 (US$M)	Trailing P/E as of 9-Sep-14 (Times)	Projected P/E as of 9-Sep-14 (Times)
General Electric (GE)	US	31-Dec-13	656,560.00	261,884.89	18.45	15.55
Berkshire Hathaway (BH)	US	31-Dec-13	484,931.00	339,803.26	22.21	20.87
Siemens	Germany	31-Sep-13	131,985.71	112,371.34	17.16	14.94
ABB	Switzerland	31-Dec-13	48,064.00	53,140.52	20.48	17.71

Source: Bloomberg, Company Annual Reports, Author's analysis

FIGURE 3: PRICE EARNINGS RATIO OF ASIAN VS. NON-ASIAN CONGLOMERATES (AS OF 9 SEPTEMBER 2014)



Source: Bloomberg

asset values tend to be lower in Asia, and the operating currencies of Asian conglomerates like RIL and SMC tend to be weak. But what is striking is that the trailing and projected P/E ratios of the Asian conglomerates, barring CRE and SIME, are lower than those of the selected U.S.-based and European conglomerates (refer to Figure 3). This could be due to two reasons. First, portfolio managers managing USD-denominated portfolios probably display familiarity and hindsight biases—they tend to be more familiar with companies that are located in the regions where they operate, and hence allocate a greater share of investments to the stocks with which they are familiar. U.S.-based and European stocks' trailing P/Es are higher than those of Asian conglomerate stocks. This leads the fund managers to believe that the trend will be sustained in the future. Fund managers who are willing to familiarise themselves with the intricacies and risks of Asian markets can greatly benefit from investing in these stocks.

Second, awareness of the performance and potential of Asian conglomerate stocks is limited. Asian conglomerates must showcase their USD-denominated stock performance and their suitability as constituents of various investment themes, such as a global large cap portfolio and a global diversified portfolio, to attract higher equity investments. In short, Asian conglomerates should raise their visibility and 'market' themselves to global investors.

Another factor that supports the case for higher investments in Asian conglomerate equities is that as most of their business is focused on high growth areas outside the U.S., the correlation between the individual stock and S&P 500 is low to medium. Hence, these stocks may be used to enhance returns, impart stability and diversify a U.S.-focused or USD-denominated equity portfolio. ASEAN alone comprises a US$625 million market with a growth rate that is several multiples that of the U.S. or Europe. Astute investors will see the upside in investing in these companies due to the huge economic potential offered by the region. This has yet to be priced into their investment strategies.

An opportunity for investment

The research implies that Asian conglomerate stocks—especially JMH and RIL that have delivered higher and more stable returns than S&P 500 and have demonstrated lower correlation with S&P 500—are undervalued, that is, the equity markets value a dollar of earnings of U.S.-based and European conglomerates more than a dollar of earnings of Asian conglomerates. This indicates that there exist attractive investment options in the Asian conglomerate equities space.

The current research can be developed further. First, it opens up ideas and opportunities to look at a larger sample of conglomerates in Asia Pacific and other regions outside the U.S., whose risk-adjusted return would enable portfolio managers to generate an alpha return (excess return of a stock over the benchmark index return) in the medium-to long-term. Second, this study has looked at conglomerates as they are representative of a macro attitude toward the region. In the future, research needs to be extended to pure play industries such as energy, telecommunications, consumer durables, banks and the like. The leading stocks of each of these industries can be benchmarked against the respective U.S. and global index to identify other attractive investment opportunities and determine if Asian equities as a whole have attracted the quantum of investment that is in line with their performance and prospects.

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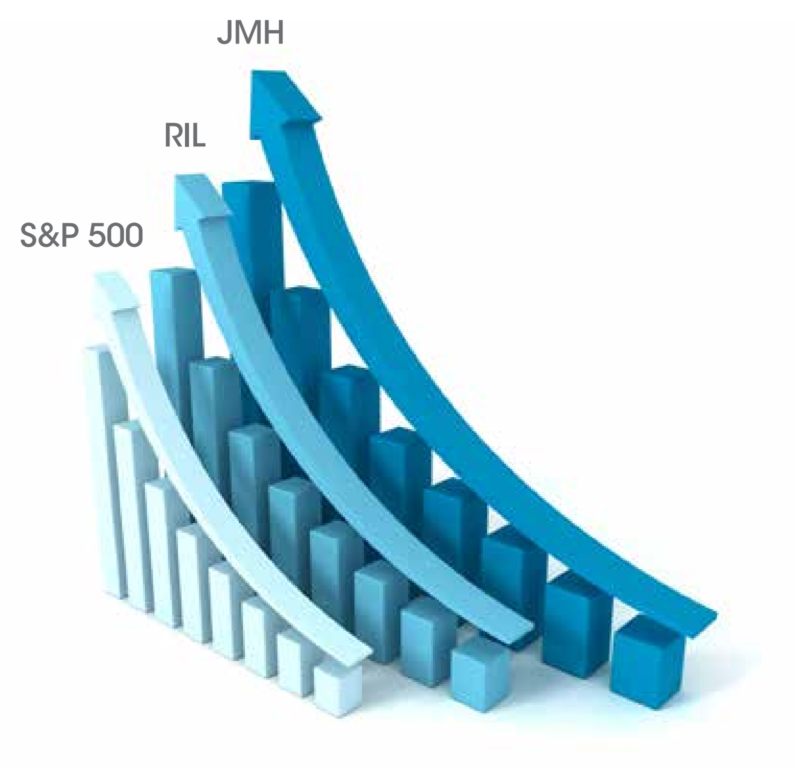
The information and data for this article is drawn from the public domain and has been obtained from the annual reports of the companies covered, Yahoo Finance and Bloomberg. The views expressed in this article are the author's own views and do not represent those of her organisation.



Reference

[i] South Korean chaebols like Samsung, Hyundai and LG are not included because only specific subsidiaries such as Samsung Electronics, Hyundai Motors and LG Electronics are listed. Frequently, the chaebol's holding company is unlisted and consolidated financials are not available.

[ii] These companies are Keppel Corporation, China Resources Enterprises and Sime Darby Berhad.

[iii] Standard deviation is a measure of the dispersion of set of data from its mean. The more spread apart the data, the higher the standard deviation.

[iv] Coefficient of variation was calculated for the period January 1, 2000 to June 30, 2014 for RIL, JMH, SMC and S&P 500. For KC, the time period under consideration was May 2, 2007 to June 30, 2014.

[v] Correlation is a statistical measure that determines the degree to which the movement of two variables are associated. Correlation values range from -1 to +1. A correlation of -1 indicates that two variables are perfectly negatively correlated i.e., they move almost always in opposite directions. A correlation of +1 indicates that the variables are perfectly positively correlated. A zero correlation indicates that the variables are not correlated. Correlation does not imply causation.

[vi] Price earnings (P/E) ratio is a valuation ratio of a company's current share price compared to its per-share earnings. In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. The P/E ratio, on a standalone basis, is of limited utility. It is usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E.